

State of California

Franchise Tax Board-Legislative Services Bureau
PO Box 1468
Sacramento, CA 95812-1468

Telephone: (916)845-4326
ATSS: 468-4326
FAX: (916)845-5472

Legislative Change No.

01-37

Bill Number: AB 1115

Author: AR&T Committee

Chapter Number: 01-920

Laws Affecting Franchise Tax Board: Sections 17015.5, 17039, 17041, 17055, 17062, 17063, 17301, 17301.3, 17301.4, 17301.5, 17303, 17304, 17306, 17307, 17310, 17554, 17734, 17854, 17935, 17951, 17952, 17952.5, 17953, 17954, 17955, 19322.1, 19556, 23036, and 23453 of the Revenue and Taxation Code

Date Filed with the Secretary of the State: October 14, 2001

SUBJECT: Nonresident Taxation/Coordination of Minimum Tax Credit with Credits that Reduce Tax Below Tentative Minimum Tax/Full Payment Rule/ Usage of Tax Credit by Holders of Interests in Pass-Through Entities/ Disclosure of Return and Return Information for Personnel Matters/ Limited Partnership Tax Technical Change

Assembly Bill 1115 (Assembly Revenue and Taxation Committee), as enacted on October 14, 2001, made the following changes to California law:

R&TC Section 17015.5 (new)

Adds R&TC Section 17015.5 to provide a definition of "part-year resident."

R&TC Section 17039

(1) Amends R&TC Sections 17039 to require that AMTC be applied **before** any credit that can reduce regular tax below the TMT.

(2) Also amends R&TC Section 17039 to provide a general default rule to allow holders of interests in pass-through entities, irrespective of the taxable year of the holder, to claim the pass-through credit. The general default rule applies even if the pass-through entity files its returns on a fiscal year different than that of the holder of the interest and even if the operative date of the credit has expired.

R&TC Section 17041

(1) **Tax Calculation.** Specifies in R&TC Section 17041 that when computing the rate of tax to be applied to the tax base (California sourced taxable income of the nonresident or part-year resident), the calculation of the rate would be made as if:

- the nonresident or part-year resident were a resident of this state for the taxable year; and

Bureau Director

Brian Putler

Date

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- as if the nonresident or part-year resident were a resident of this state for all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions.

This means that nonresidents or part-year residents will calculate their tax rate by determining the tax on their entire taxable income in the same manner as residents would use, and then divide that tax by the income that the tax was calculated upon. That rate would then be applied to the tax base (California sourced taxable income of the nonresident or part-year resident).

Expressed as a mathematical formula as follows:

$$\frac{\text{Tax on Total TI}}{\text{Total TI}} \times \text{California Source TI} = \text{Tax Imposed}$$

(2) **Residents.** In order to ensure that residents compute their entire taxable income in that manner, this bill specifies in subdivisions (a) and (c) of R&TC Section 17041 that taxable income of a resident for the entire taxable year is computed as if the resident were a resident of this state for the current taxable year and all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions.

This means that in computing the taxable amount of pension distributions of a **current-year resident** who had not been a resident in some or all of the preceding years, the current-year resident would make that calculation for the current year as if the current-year resident were a resident of this state for all prior taxable years.

Thus, in the case of an Individual Retirement Account (IRA), basis adjustments for all prior years would be determined under California law. For example, if a deduction would have been denied under California law for any prior year, the taxpayer's basis in the IRA would be increased by that amount. Moreover, a nonresident coming into California will not receive a stepped-up basis for annual contributions and earnings thereon simply because the individual was a nonresident when the contributions were made. This conforms the rules for determining basis in an IRA to the rules for determining basis of other types of deferred compensation.

This bill retains the rule that prohibits California from taxing, on a "source" basis, the pension income of a person who is a nonresident when the payment is received. This is consistent with the federal enactment of the provisions of Section 114 of Title 4 of the United States Code, relating to limitation on state income taxation of certain pension income that allows only the state of residence to impose a tax on this pension income. Thus, **no change** is made by this bill to the taxation of IRA or pension income of a person who is a nonresident of California when the payment is received.

(3) **Nonresidents and part-year residents.** The changes specified by this language would accomplish the following results:

- The bill defines the term "taxable income of a nonresident or part-year resident" in subdivision (i) of R&TC Section 17041 and specifies that that calculation is made by a nonresident solely by reference to gross income and deductions derived from sources within this state. In addition, with respect to part-year residents, this bill specifies that the term also includes all items of gross income and all deductions, regardless of source, for any part of the taxable year during that the taxpayer is a resident of this state.

- The NOL deduction allowed in computing the "taxable income of a nonresident or part-year resident" is no longer limited by the amount of NOL allowed in computing the "amount of total taxable income" but is a separate computation.
- Clarifies that the amount of passive activity losses (PALs) allowed in computing the "taxable income of a nonresident or part-year resident" is not limited by the amounts used in computing the PAL allowed in computing the "amount of total taxable income" but instead is a separate computation with respect to the PAL activities having a California source. In this calculation, the nonresident or part-year resident is allowed the \$25,000 offset for rental real estate activities, subject to the phase-out rules. The suspension and release of a California-source PAL in computing the "amount of total taxable income" is a separate computation and is not limited by the amounts used in computing the PAL allowed in computing the "amount of total taxable income."
- Capital loss carryovers and capital loss limitations of nonresidents are no longer limited to or recognized by reference to capital loss carryovers and capital loss limitations used in computing the "amount of total taxable income." Instead, such carryovers and limitations are separate computations with respect to the capital losses having a California source and entering into the "taxable income of a nonresident or part-year resident." For example, the \$3,000 capital loss limitation is applied to capital losses entering into the computation of the "taxable income of a nonresident or part-year resident" without regard to the amount allowed in computing the "amount of total taxable income."
- The character of gains or losses on the sale or exchange of an IRC Section 1231 item (property used in the trade or business or certain involuntary conversions) entering into the computation of the "taxable income of a nonresident or part-year resident" is determined without regard to the character of gain or loss of that IRC Section 1231 item determined in computing the "amount of total taxable income."

R&TC Section 17055

Amends R&TC Section 17055, relating to credits allowed for nonresidents and part-year residents, to refer to the proper ratio under the changes to subdivision (i) of R&TC Section 17041.

R&TC Section 17062

Amends R&TC Section 17062, relating to the calculation of alternative minimum tax (AMT), to reflect the changes being made to the structure of R&TC Section 17041 to make the two sections consistent.

R&TC Section 17063

Amends R&TC Sections 17063 to require that AMTC be applied **before** any credit that can reduce regular tax below the TMT.

R&TC Section 17301

Amends R&TC Section 17301 to rephrase the section to provide rules for the computation of "taxable income of a nonresident or part-year resident" under paragraph (1) of subdivision (i) of R&TC Section 17041.

R&TC Section 17301.3 (new)

Adds a definition of "California adjusted gross income" in new R&TC Section 17301.3 to allow cross-references to that term in other sections.

R&TC Section 17301.4 (new)

Adds a definition of "total adjusted gross income" in new R&TC Section 17301.4 to allow cross-references to that term in other sections.

R&TC Section 17301.5 (new)

Adds a definition of "total taxable income" in new R&TC Section 17301.5 to allow cross-references to that term in other sections.

R&TC Section 17303 (repealed)

Repeals R&TC Section 17303 as it is unnecessary due to the revisions being made to subdivision (i) of R&TC Section 17041.

R&TC Section 17304 (new)

In order to utilize California source TI and total TI in computing the tax on nonresidents and part-year residents, the bill adds new R&TC Section 17304 to provide the rules for prorating the standard deduction or itemized deductions allowed in computing "taxable income of a nonresident or part-year resident." The total standard deduction or total itemized deductions will be prorated by the ratio of California source AGI to total AGI to determine the amount of California source standard deduction or itemized deductions allowed in arriving at California source TI.

R&TC Section 17306 (new)

Adds R&TC Section 17306, relating to limitations based on "adjusted gross income," to provide that those limitations would be based on "California adjusted gross income" in the computation of the "taxable income of a nonresident or part-year resident" and not by the limitation used in computing the "total taxable income."

R&TC Section 17307 (new)

Adds R&TC Section 17307, relating to California IRA and Keogh deductions of a nonresident, to provide that these deductions would be limited by compensation or earned income entering into the computation of the "taxable income of a nonresident or part-year resident" and not by the limitation used in computing the "total adjusted gross income."

R&TC Section 17310 (repealed)

Repeals R&TC Section 17310 to reflect the changes being made to subdivision (i) of R&TC Section 17041 that contains the rules for all carryover deductions and specifies rules relating to NOLs.

R&TC Section 17554 (repealed)

Repeals R&TC Section 17554 to reflect the changes being made to subdivisions (a) and (i) of R&TC Section 17041 that contains the rules for all carryover items.

R&TC Section 17734

Amends R&TC Section 17734 to rephrase the section to define what items of income and deductions a nonresident beneficiary of an estate or trust is required to include in the computation of "taxable income of a nonresident or part-year resident." Taxable income of a nonresident or part-year resident would include only items of income and deduction derived by the estate or trust from sources within this state.

R&TC Section 17854

Amends R&TC Section 17854 to rephrase the section to provide rules for the computation of "taxable income of a nonresident or part-year resident" under paragraph (1) of subdivision (i) of R&TC Section 17041.

R&TC Section 17935

Amends R&TC Section 17935 to make a technical change to remove the term "minimum tax" in reference to the annual tax on limited partnerships in California. Reference to the term "minimum tax" is replaced with the term "tax imposed by this chapter."

R&TC Section 17951

Amends R&TC Section 17951 to rephrase the section to provide rules for the computation of "taxable income of a nonresident or part-year resident" under paragraph (1) of subdivision (i) of R&TC Section 17041.

R&TC Section 17952

Amends R&TC Section 17952, 17952.5, 17953, 17954, and 17955 to rephrase the section to provide rules for the computation of "taxable income of a nonresident or part-year resident" under paragraph (1) of subdivision (i) of R&TC Section 17041.

R&TC Section 17952.5

Amends R&TC Section 17952.5 to rephrase the section to provide rules for the computation of "taxable income of a nonresident or part-year resident" under paragraph (1) of subdivision (i) of R&TC Section 17041.

R&TC Section 17953

Amends R&TC Section 17953 to rephrase the section to provide rules for the computation of "taxable income of a nonresident or part-year resident" under paragraph (1) of subdivision (i) of R&TC Section 17041.

R&TC Section 17954

Amends R&TC Section 17954 to rephrase the section to provide rules for the computation of "taxable income of a nonresident or part-year resident" under paragraph (1) of subdivision (i) of R&TC Section 17041.

R&TC Section 17955

Amends R&TC Section 17955 to rephrase the section to provide rules for the computation of "taxable income of a nonresident or part-year resident" under paragraph (1) of subdivision (i) of R&TC Section 17041.

R&TC Section 19322.1 (new)

Adds R&TC Section 19322.1 to allow taxpayers that are making installment payments to satisfy a tax liability to file a protective refund claim before their taxes are fully paid.

R&TC Section 19556 (new)

Adds R&TC Section 19556 to clearly authorize disclosure of confidential taxpayer information to an FTB employee or former FTB employee, a legal representative of such employee, an Administrative Law Judge (ALJ), or a Superior Court Judge for use in disciplinary actions. The disclosures authorized by this bill are only for personnel matters brought under the Civil Service Act or the Ralph C. Dills Act.

R&TC Section 23036

(1) Amends R&TC Sections 23036 to require that AMTC be applied **before** any credit that can reduce regular tax below the TMT.

(2) Also amends R&TC Section 23036 to provide a general default rule to allow holders of interests in pass-through entities, irrespective of the taxable year of the holder, to claim the pass-through credit. The general default rule applies even if the pass-through entity files its returns on a fiscal year different than that of the holder of the interest and even if the operative date of the credit has expired.

R&TC Section 23453

Amends R&TC Sections 23453 to require that AMTC be applied **before** any credit that can reduce regular tax below the TMT.

This act is effective January 1, 2002, and applies to taxable years beginning on or after that date.

This act will not require any reports by the department to the Legislature.